Classifying Institutional Investors

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I. INTRODUCTION

Shareholders as such are not entitled to participate in corporate decision-making except by electing directors periodically and approving major corporate changes first proposed by the board. This feature of the corporation—centralized management—is fundamental to corporate law. Yet the past several years have seen a heated debate among academics, practitioners, and lawmakers over whether shareholders’ power to intervene in corporate decision-making should be increased.¹

The general problem, faced as much by agency, guardianship, trust, and partnership as by corporate law, is how best to allocate decision-making authority when appointed managers manage a business for owners. The optimal allocation of decision-making authority depends on the decision-making goal, maximizing owner wealth, for example, and on the incentives and competence of managers and owners relative to that goal. Because these factors differ in different areas of the law, the optimal allocation of decision-making authority—and the allocation the law has actually achieved—is different in agency, guardianship, trust, partnership, and in corporate law as well.

Allocations of decision-making authority range from those that perfectly insulate managers to those that subject them to a perfect duty of obedience. Dutch corporate law²

¹. Professor Lucian Bebchuk and I have taken contrary views on this question: he supports shareholder initiative while I do not. Compare Lucian A. Bebchuk, The Case for Increasing Shareholder Power, 118 HARV. L. REV. 833, 836 (2005) (arguing that shareholders should be able to act on at least certain important categories of corporate decisions on their own initiative) with K.A.D. Camara, Shareholder Voting and the Bundling Problem in Corporate Law, 2004 WISC. L. REV. 1425, 1428, 1453-54 (arguing that the ability of directors to bundle decisions cannot justify shareholder initiative and that there is no other reason to expect that an increased power of shareholder intervention would overcome the existing problems with shareholder voting as a corporate control mechanism). Three economists have circulated a working paper containing preliminary empirical tests of some of the hypotheses offered in my Wisconsin Law Review Article. See Joseph Weber et al., Do Voting Rights Matter?: Evidence from the Adoption of Equity-Based Compensation Plans (Oct. 2003) (working paper) (currently in submission) available at http://icf.som.yale.edu/pdf/seminars04-05/Balachandran.pdf (last visited Mar. 9, 2005).

². The “structure regime,” applicable to certain large Dutch corporations, equips them with self-perpetuating supervisory boards. See REINER R. KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW 36
and the common law of guardianship and trust\(^3\) are at one extreme: managers are not even elected. The German law of close corporations\(^4\) and the common law of agency\(^5\) are at the other extreme: owners can bind managers on any subject related to the business. Delaware law falls between these extremes: shareholders periodically elect directors and ratify board-proposed organic changes, but cannot make corporate decisions on their own initiative.

Academics, Professor Lucian Bebchuk most prominently, have recently urged that shareholders be empowered to make major corporate decisions—on dividends, sales of the firm, and reincorporation, for instance—on their own initiative.\(^6\) In this Article, I argue against such “shareholder-initiative” proposals and defend the existing allocation of decision-making authority.\(^7\) The argument for shareholder initiative depends on two claims: first, that shareholder initiative would allow shareholders to use shareholder voting effectively; and second, that they would use it to do something good—viz., to increase shareholder wealth.\(^8\)

In Articles published late last year, Bebchuk and I took opposite positions on the first of these claims. Bebchuk contended that shareholder initiative solves the bundling problem, which is the foremost obstacle to effective shareholder voting. Hence

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4. See, e.g., Kraakman et al., supra note 2, at 48 (describing the Gesellschaft mit beschränkter Haftung (The German limited-liability company) (GmbH) form as exemplifying the most far-reaching application of direct voting).

5. See, e.g., Floyd R. Mechem, A Treatise on the Law of Agency § 1244 (2d ed. 1914) (discussing the agent’s duty of obedience); Restatement (2d) of Agency § 385 (defining an agent’s duty to obey).

6. Bebchuk, supra note 1, at 835.

7. See also Camara, supra note 1.

8. Although shareholder wealth maximization is the corporate-law end most frequently endorsed in the literature, it has not been entirely uncontroversial. See generally William T. Allen et al., The Great Takeover Debate: A Meditation on Bridging the Conceptual Divide, 69 U. Chi. L. Rev. 1067 (2002) (summarizing the debate); David Millon, Theories of the Corporation, 1990 Duke L.J. 201 (same); Symposium, New Directions in Corporate Law, 50 Wash. & Lee L. Rev. 1373 (1993) (particularly David Millon’s Communitarians, Contractarians, and the Crisis in Corporate Law, which summarizes the debate from a perspective against shareholder wealth maximization); Symposium, Corporate Stakeholder Conference, 43 U. Toronto L.J. 297 (1993) (same); Lawrence E. Mitchell, A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes, 70 Tex. L. Rev. 579 (1992) (providing a more practical contribution on the side of those against shareholder wealth maximization).

Shareholder-wealth-maximizing corporate decision-makers will take shareholder interests into account if so doing contributes to shareholder wealth maximization. To affirm the primacy of shareholder wealth maximization is not to reject all consideration of stakeholder interests—the interests of these groups often will coincide. See A.B.A. Comm. on Corp. Laws, Other Constituency Statutes: Potential for Confusion, 45 Bus. Law. 2253 (1990) (arguing that a “constituency” provision should not be included in the Revised Model Business Corporations Act); John C. Coffee, Jr., Shareholders Versus Managers, 85 Mich. L. Rev. 1, 84-86 (1986) (considering whether the law of fiduciary duty permits directors to consider the interests of nonshareholder constituencies); Ronald Daniels, Stakeholders and Takeovers: Can Contractarianism be Compassionate, 43 U. Toronto L.J. 315, 316-17 (1993) (considering whether stakeholder protection can be justified based on implicit contract rationales).
shareholder initiative would make shareholder voting an effective corporate control mechanism.\textsuperscript{9} I contended that other obstacles explain shareholder voting’s ineffectiveness, obstacles that would only be compounded by shareholder initiative. Hence shareholder initiative would not make shareholder voting an effective control mechanism.\textsuperscript{10}

In this Article, I take up the second claim of the argument for shareholder initiative and contend that even if shareholder initiative allowed shareholders to vote effectively, shareholders would still not vote to maximize shareholder wealth. Institutional investors, because their holdings are large, are the shareholders most likely to overcome the myriad of obstacles to the effective use of shareholder voting.\textsuperscript{11} Part II offers a brief argument in support of this claim, which I take to be uncontroversial.

If shareholder initiative would allow institutional investors to use shareholder voting

\textsuperscript{9} See generally Bebchuk, supra note 1, at 876-79 (contending that shareholder intervention power is significant in several regards, including indirect control over management’s decisions to make changes and direct control over institutional investors decisions to make changes in corporate governance arrangements).

\textsuperscript{10} See Camara, supra note 1, at 1470-84 (explaining why shareholder voting is ineffective).

\textsuperscript{11} Institutional investors also facilitate other corporate control mechanisms, such as the market for corporate control. See, e.g., Robert C. Clark, Corporate Law, 94-95 (1986) (discussing the free-rider problem with small, individual shareholders); Andrei Shleifer & Robert W. Vishny, Large Shareholders and Corporate Control, 94 J. Pol. Econ. 461 (1986) (asserting that large shareholders are valuable monitors of firm managers).

effectively, and if institutional investors would use shareholder voting to increase shareholder wealth, then, insofar as increasing shareholder wealth is corporate law’s goal, shareholder initiative is desirable. As Part III explains, however, market, political, and social incentive-creating forces drive institutional investors to value things other than shareholder wealth: for union pension funds, higher wages; for public pension funds, the interests of the electorate. Part III sets out the conflicts of interest between institutional investors as institutions (unions, state agents, etc.) and as shareholders. These conflicts of interest suggest that empowering institutional investors might well reduce shareholder wealth.

Proponents of shareholder initiative point out that shareholder initiative empowers only shareholder majorities. And, they contend, no majority ever favors the same sectional interest. Consequently, proposals that advance sectional interests at the expense of shareholder wealth will never gain majority support. Part IV demonstrates that this is a non sequitur because proposals that sufficiently advance the sectional interests of a majority of shareholders will receive majority support even though they reduce shareholder wealth. Shareholder initiative, therefore, cannot be justified as a way of increasing shareholder wealth—and, consequently, the arguments for shareholder initiative advanced by its academic proponents are unpersuasive.

Part IV goes on, however, to identify three alternative ends for corporate law that might justify shareholder initiative: redistribution of corporate profit, governance by a desirable process, and compliance with non-corporate-law legal constraints. The desirability of an intervention power depends on the desirability of these (or other) non-shareholder-wealth-maximization ends. Part V concludes.

II. INSTITUTIONAL INVESTORS AND COLLECTIVE ACTION

Institutional investors are the shareholders most likely to use shareholder voting effectively—that is, intelligently in service of their own interests. This Part briefly explains why this occurs. That institutional investors are most likely to use voting effectively does not, however, establish that shareholder intervention is desirable. Part III shows that the interests of institutional investors would often lead them to sacrifice shareholder wealth to obtain something else they value.

There are seven principal obstacles to effective shareholder voting: (1) shareholders’ inadequate incentives to investigate the quality of corporate decisions; (2) externalities...
of voting;\textsuperscript{14} (3) bounded rationality;\textsuperscript{15} (4) campaign costs;\textsuperscript{16} (5) costs of redundant decision-making;\textsuperscript{17} (6) costs of inconsistency;\textsuperscript{18} and (7) the need for fiduciary duties between shareholders.\textsuperscript{19} The literature divides these obstacles into those that cause shareholders not to vote, (1) and (2), and those that cause shareholders to vote badly.\textsuperscript{20} But the decision to vote is itself a decision. Shareholders may decide to vote despite inadequate information because they overestimate their decision-making competence or

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\textsuperscript{14} Shareholders who own less than the entire firm do not bear the full cost of incorrect corporate decisions. Part of this cost is borne by the other shareholders. Therefore, when a shareholder votes for a shareholder-wealth-reducing decision, he imposes a negative externality of voting on the other shareholders. Similarly, a shareholder who votes correctly imposes a positive externality of voting on the other shareholders. If those other voters are his competitors, for example in the case of mutual funds with overlapping holdings, this serves as a further disincentive to spend money on voting or investigating potential corporate decisions. See Camara, \textit{supra} note 1, at 1447-50; see also Frank H. Easterbrook & Daniel R. Fischel, \textit{Voting in Corporate Law}, 26 J.L. & Econ. 395, 413-15, 419 (1983) (introducing the idea of externalities of voting).

\textsuperscript{15} Shareholders, like the rest of us, exhibit imperfect rationality, and, especially if they own less than the entire firm, are likely to underinvest in rationality aids such as professional advice. This increases the likelihood that their decisions will reduce shareholder wealth. See Camara, \textit{supra} note 1, at 1478. On bounded rationality, see generally Herbert A. Simon, \textit{Bounded Rationality, in 1 THE NEW PALGRAVE DICTIONARY OF ECONOMICS} 266–68 (J. Eastwell et al. eds., 1987) (defining bounded rationality as the term “used to designate rational choice that takes into account the cognitive limitations of the decision maker”); DANIEL KAHNEMAN & AMOS TVERSKY, \textit{CHOICES, VALUES, AND FRAMES} (2000) (discussing assumptions of rationality); Donald C. Langevoort, \textit{Organized Illusion: Behavioral Theory of Why Corporations Mislead Stock Market Investors (and Cause Other Social Harms)}, in \textit{BEHAVIORAL LAW & ECONOMICS} 144 (Cass R. Sunstein ed., 2000) (recognizing and defining bounded rationality of officers and directors).

\textsuperscript{16} When shareholders (or some other group) want a corporate decision, they must convince whoever holds corporate decision-making authority. The more diffuse that authority is—the more people there are to convince—the more costly the campaigning process will be. Shareholder initiative shifts decision-making authority from a relatively small board of directors to a relatively large group of shareholders, and so increases the costs of campaigning. See, e.g., HENRY HANSMANN, \textit{THE OWNERSHIP OF ENTERPRISE} 39–42 (1996) (discussing the costs of collective decision-making); see also Camara, \textit{supra} note 1, at 1476.

\textsuperscript{17} Arriving at a correct corporate decision requires costly investigation, education, and reflection. The more decision-makers there are, and the greater are the barriers to pooling decision-making costs, the greater the sum of these costs will be for any particular decision. A decision is cheaper if ten men must come to it than if one hundred must. See Camara, \textit{supra} note 1, at 1472.

\textsuperscript{18} Consistency in corporate decision-making is valuable because it facilitates long-term planning and makes incomplete contracts with labor, customers, suppliers, and others less costly. When contracting partners can rely on consistent firm behavior, they will require fewer explicit contractual provisions. Explicit provisions are costly not only because they must be drafted, but also because second-best provisions may have to be adopted in order to ensure their enforceability by a court and that breaches are observable and verifiable. See, e.g., id. at 1478-80 (stating that increased shareholder voting power often reduces consistency); Gordon, \textit{supra} note 1, at 361-62 (noting the problem of inconsistency, suggested here by possibility of voting cycles); Martin Lipton, \textit{Pills, Polls and Professors Redux}, 69 U. CHI. L. Rev. 1037, 1059–60 (2002) (observing the value of consistency); Margaret M. Blair & Lynn A. Stout, \textit{A Team Production Theory of Corporate Law}, 85 Va. L. Rev. 247, 315 (1999) [hereinafter Blair & Stout, \textit{A Team Production Theory}] (same); Lynn A. Stout, \textit{Do Antitakeover Defenses Decrease Shareholder Wealth? The Ex Post/Ex Ante Valuation Problem in Response Symposium}, 55 Stan. L. Rev. 845, 847–51 (2002) (same).

\textsuperscript{19} The law frequently imposes fiduciary duties on one who stands in a relationship to another that gives him power over the interests of the other. See Camara, \textit{supra} note 1, at Part III.G.

\textsuperscript{20} See, e.g., Black, \textit{Shareholder Passivity, supra} note 11, at 523 (arguing that a change in the legal rules governing shareholder voting would alleviate shareholder passivity); Black, \textit{Agents Watching Agents, supra} note 11, at 814 (stating that managerial control over the shareholder voting agenda leads to bad voting decisions).
underestimate the incentives or competence of directors. Legal rules that encourage voting only make matters worse: shareholders vote, but badly. Investors with large holdings—institutional investors—are most likely to overcome these obstacles. Because of their large holdings, they are more likely to receive a large enough share of the costs and benefits of corporate decisions to invest in making them well. This diminishes the problem of negative voting externalities and the need for shareholder fiduciary duties. Campaign costs are lower when institutional investors serve as corporate decision-makers because there are fewer of them than there are investors generally. Consistency is easier to achieve because directors and institutional investors are a relatively small group invested for the long term. Institutional investors enjoy well-trained staffs and professional advice, both of which reduce the problem of bounded rationality. In sum, while institutional investors face the same obstacles to shareholder voting, they are better able to overcome them than are shareholders generally.

III. INSTITUTIONAL INVESTORS CLASSIFIED

Institutional investors care about things other than increasing shareholder wealth.


23. Consider a typical statement:

If legal protection does not give enough control rights to small investors to induce them to part with their money, then perhaps investors can get more effective control rights by being large. When control rights are concentrated in the hands of a small number of investors with a collectively large cash flow stake, concerted action by investors is much easier than when control rights, such as votes, are split among many of them . . . . In effect, concentration of ownership leverages up legal protection.


24. See, e.g., Barnard, The Proxy Revisited, supra note 11, at 81-83 (discussing institutional investors’ increased willingness to participate); Black, Agents Watching Agents, supra note 11, at 822 (stating the effects of holding size on a shareholder’s likelihood of action); Black, Empirical Evidence, supra note 11, at 917 (reviewing empirical studies and finding stronger support for the proposition that large, as opposed to institutional, shareholders increase shareholder value); Black, Shareholder Passivity, supra note 11, at 567–89 (describing factors in large institutions’ voting decisions).
Therefore, they will sometimes be willing to sacrifice shareholder wealth to obtain these other things. Further, institutions make decisions through actual people—their controllers. Even if an institution cared only about maximizing shareholder wealth, its controllers’ mistakes or imperfect loyalty might cause it to make shareholder-wealth-reducing decisions.

This Part identifies the ways in which the interests of institutions and controllers diverge from shareholder wealth maximization. Subpart A describes how market, political, and social forces, and insulation from these forces, shape the incentives of institutions and controllers. Subparts B, C, and D describe model institutional investors with incentives dominantly shaped by market, political, and social forces, respectively. Subpart E describes additional conflicts-of-interest, more familiar from the literature, stemming from institutional investors’ nonequity relationships with portfolio firms.

A. Incentive-Creating Forces: Market, Political, and Social

Incentive-creating forces determine the behavior of institutions and their controllers.25 These forces come in three principal types: market, political, and social. Market and political forces are external to the subject: they condition things he wants on his taking certain actions. Market forces reward actions with money, which the subject can use to buy what he wants. They include the competitive pressures of capital and executive-labor markets. Political forces reward actions with the consent of others who can give the subject what he wants. In a well-functioning political system, they include the drive to serve political ideals or the public interest. By contrast, social forces are internal to the subject: they change what he wants. They include the pressures of education and indoctrination in early life, and the psychological need to maintain a pleasing self-image while immersed in a particular cultural setting. Institutions and controllers enjoy different levels of insulation from each type of incentive-creating force. Insulation mechanisms include wealth, which insulates from market forces (the subject already has money); authority, which insulates from political forces (the subject who can command need not ask); and compulsion, which insulates from social forces (the wants of a subject without choice are irrelevant).26

25. For earlier analyses of the incentives of institutional investors, see, e.g., Black, Agents Watching Agents, supra note 11, at 876-81 (describing incentives of private and public pension funds), 885-86 (noting the agency problems with respect to money managers); Black, Shareholder Passivity, supra note 11, at 595-607 (discussing conflicts of interest of private and public pension funds, banks, insurance companies, mutual funds, and foundations); Barnard, The New Corporate Governance, supra note 11, at 1140-52 (discussing incentives of public, corporate, and union pension funds, mutual funds, insurers, bank trusts, and foundations); A.A. Somner, Jr., Corporate Governance in the Nineties: Managers vs. Institutions, 59 U. CIN. L. REV. 357, 362-67 (1990) (discussing incentives of private and public pension funds, investment companies, insurers, bank trusts, and foundations). Although this literature importantly recognizes some of the differences between institutions, it does not offer a framework for organizing those differences, nor does it offer a fully satisfactory analysis of the implications of those differences for an increased power of shareholder intervention.

26. I am currently working on an examination of incentive-creating forces and insulation mechanisms in corporate law and elsewhere. The literature in some doctrinal areas has been overly focused on one type of force or another. For example, corporate law focuses on market forces while international law focuses on political forces. If, as seems likely, the optimal incentive-creating mechanism relies on a proper balance of exposure to and insulation from the three types of incentive-creating forces, then much can be gained by crossing these doctrinal boundaries.
Corporate-law scholarship has focused principally on market forces, in part because of their strength in the corporate setting, in part because of their amenability to economic analysis. This scholarship has nevertheless led to a consensus that corporate decision-makers often are substantially insulated from market forces. There are two basic ways in which to respond to this observation. First, corporate law can attempt to reduce the insulation of corporate decision-makers from market forces. The leading corporate-law reformers have taken this approach, advocating pay for performance and a freer corporate-control market. Second, corporate law can attempt to better understand and manipulate the political and social forces that move corporate actors in the presence of market insulation. This approach is important not only because some degree of market insulation is inevitable, but also because market insulation is often created, shaped, and preserved by political and social forces. It poses difficulties for economic analysis because it involves soft data—corporate actors’ motivations—and alterable tastes—tastes for indoctrinating corporate actors is a substitute for harnessing their existing tastes. We must nevertheless pursue this second approach, aided by the ever-growing research at the intersection of moral philosophy, biology, psychology, and economics, and by work in other doctrinal areas in which the focus has been on social and political, rather than market, forces.

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27. The problem, however, is not limited to corporate-law scholarship:

[There] has been a strong preference for those facts which can be statistically or graphically presented; a specious objectivity has been bought at the cost of significant, if intangible realities.

The facts most relevant to legal study will generally be found to be what may be called moral facts.

They lie not in behavior patterns, but in attitudes and conceptions of rightness, in the obscure taboos and hidden reciprocities which permeate business and social relations.

LON L. FULLER, THE LAW IN QUEST OF ITSELF 64–65 (1940).


29. See, e.g., Bebchuk, supra note 1, at 908 (stating that increased agency costs often result from the insulation of management from market forces); Lucian A. Bebchuk, Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law, 105 HARV. L. REV. 1437, 1462-76 (1992) (stating that since small reductions in share value are unlikely to place managers in any great danger of ouster via hostile takeover or proxy contest, market conditions do not significantly reduce managerial agency problems).


31. See, e.g., KRAAKMAN ET AL., supra note 2 (calling for research into how boards operate and what the factors are that determine the quality of insulated corporate decision-making).

32. As I have said elsewhere:

The two fields [private international law and corporate law] have much to learn from each other: private international law can absorb the relatively advanced agency-cost analysis that has developed in corporate law, while corporate law can absorb the respect for nonmarket forces that is difficult to avoid in private international law.
It is useful to classify institutional investors according to the principal incentive-creating force that each faces. Such a classification structures the long list of organizations having in common large holdings. It highlights the differences between institutions and the ways in which their actions, driven by market, political, and social forces, are likely to diverge from shareholder wealth maximization. Classification emphasizes the role of nonmarket forces and the importance of market-insulation mechanisms that permit or enhance the impact of those forces.

Classification is not costless: it risks obscuring similarities and magnifying differences seized on as distinctions. Highlighting different institutions’ sectional interests obscures their common interest in increasing shareholder wealth and the considerable divergences of interest that may arise between institutions and controllers of a given type. Union pension funds all have an interest in labor practices. But one may be focused on wages, another may be concerned with outsourcing or foreign-labor-market competition, and a third may enjoy substantial insulation from political forces altogether, freeing it to focus on investment returns. My classification necessarily abstracts from institutions as they exist in the real world; it is really a classification of paradigm institutions. Real-world institutions at any particular time and place are unlikely to match my paradigm institutions perfectly. The wider this gap, the less useful the classification is to a practitioner forced to deal with real-world problems. On the other hand, the more general the analysis—the more it operates on defined institutional types when and wherever they happen to exist—the wider the range of real-world institutions to which the analysis can be adapted.

Subparts B, C, and D each describe a principal paradigm institution and two variations on the principal paradigm. Subpart B describes institutions primarily motivated by market forces. Its paradigms are the hedge fund, the mutual fund, and the venture capitalist. Subpart C does the same for political forces, using the state, public pension funds, and shareholders with a cause as paradigms. Subpart D addresses social forces, using the gentleman of affairs, founding families and their heirs, and wealthy managers as paradigms.

Institutional investors often experience other conflicts of interest brought on by nonequity relationships with portfolio firms. A market-pressured investor with nonequity relationships will maximize not shareholder value, but the value of all of his relationships taken together. This is the source of the well-known debt-equity conflict in corporate finance. Subpart E discusses multiple-relationship conflicts using private pension funds, bank trust departments, and insurers as examples.


33. Further, if institutions must exercise their corporate powers in a way that is visible to incumbent management, and if these secondary relationships are profitable and subject to termination by incumbent management, incumbent management can extort desired exercises of institutions’ corporate powers in exchange for profitable secondary relationships. See Camara, supra note 1, at 1472-74 (discussing what are referred to as “special punishments”).

B. Market-Driven Investors

Market-driven investors are motivated principally by financial gain. Competition for capital drives them to increase the return they offer their investors. But the strategies they use may not involve maximizing the value of individual portfolio firms, and the managers they employ may be incompetent, disloyal, or both. While market-driven investors are closest to being exclusively focused on shareholder wealth maximization, their different competitive strategies lead to divergence from this goal.

1. Hedge Funds

The principal paradigm of the market-driven institution is the hedge fund. It buys substantial stakes in portfolio firms hoping to profit later by selling into the market. Its investors are substantial and sophisticated, willing and able to condition investment on fund performance. Relative to mutual funds, hedge funds trade away access to the capital of smaller, less sophisticated investors for increased investment flexibility. In particular, legal restrictions on risky or complicated investment techniques are relaxed, as is the requirement of daily redemption. Because its controllers’ compensation is determined by the pool of assets under management, the failure of investors to invest is felt immediately. The market for future employment of fund controllers is sophisticated and capable of assessing past fund performance. Furthermore, fund controllers operate in a climate designed for the hard-headed pursuit of money. Their colleagues are pursuers of money. They never see the communities or ecological systems disrupted by the operations of portfolio firms. They have no connection to their employees, and are mainly invisible to the nonfinancial world. The hedge fund thus faces an impressive combination of market forces: stiff competition in the capital market, an absence of secondary relationships with portfolio firms, a strong connection between manager compensation and fund performance, a strong connection between exit opportunities in the labor market and fund performance, and insulation from competing social and political pressures.

2. Mutual Funds

Mutual funds accept money from investors for further investment. Their investors are individuals or other institutions, such as corporate pension plans. Mutual funds stand ready to buy back their shares at the market price of their portfolios calculated on a daily basis. Each fund hires an investment advisor who receives a fee, usually tied to the size of the fund, for managing its investments. Independent agencies and financial periodicals regularly publish fund and performance reviews, and funds regularly disclose their holdings. Fund shares are marketed directly and through broker-dealers who act as

37. On the mutual fund industry (and for general propositions in the text), see generally id.
38. This is what it means to be an open-end rather than a close-end fund.
knowledgeable intermediaries for individual investors.

One would expect easily available performance information and high liquidity to make the competition between mutual funds for capital intense. However, the movement of capital into and out of mutual funds is very sensitive to performance only for the best-performing funds. This suggests that many investors buy and hold: moneys invested in mutual funds are not touched for long periods, regardless of changes in performance. Such a strategy may make sense given the limited investment-decision-making capacity of many mutual-fund investors.

Funds are either active or indexed. Active funds employ fund managers to select profitable investments. They perform well to the extent these managers are able to identify profitable firms or sectors in advance of the market. Indexed funds instead aim to match the return of an antecedently selected group of securities, such as the S&P 500, as cheaply as possible. Whereas active funds compete on skill, indexed funds compete on cost. Active funds fare better in markets where information is less quickly absorbed: the market in small firms or foreign firms operating in regimes with less or less transparent disclosure, for instance.

Fund objectives diverge from the maximization of the share value of portfolio companies. First, active funds have no preference between improving the value of a portfolio company and selling to invest elsewhere. If these options affect the value of shares in the fund equally, fund managers have no incentive to intervene in corporate governance rather than sell and invest elsewhere. Fund managers’ expertise lies more often in investment selection than corporate governance; the extra cost of participating in corporate governance must be justified by increased profitability.

Second, because labor markets for fund managers are imperfectly informed, they have an incentive to mimic the behavior of other fund managers. Managers expect that future potential employers will assess their performance at the fund. But these employers have trouble differentiating between investment advisors who make good investment decisions ex ante that turn out badly ex post, and those who make bad investment decisions that turn out badly ex post. Thus, if a manager’s decisions are similar to those of other advisors, he will not be identified as particularly bad. Imperfectly informed labor markets distort fund managers’ investment-picking incentives. We should expect the

40. See Erik R. Sirri & Peter Tufano, *Competition and Change in the Mutual Fund Industry*, in FINANCIAL SERVICES: PERSPECTIVES AND CHALLENGES (Samuel L. Hayes ed., 1993) (finding that past performance can have an impact on net inflows into a fund).

same distortion in fund managers’ decisions on corporate governance: decisions will be made not on their merits but because others are also making them. Such error cascades might easily be begun by prominent academic proposals adopted by one or two large funds, or by an external advisor, such as Institutional Shareholder Services (ISS).

Third, indexed funds seek to increase firm value only to attract investment from vehicles other than indexed mutual funds. Because indexed funds share a portfolio, increasing the performance of portfolio firms cannot affect their relative performance—only reducing expenses can do that. Intelligent participation in voting campaigns is likely to increase expenses, with any benefit redounding to all funds matching the same index. This collective-action problem can be surmounted by having a big enough pool of fund resources devoted to corporate governance matters. In the United States, there is the Council of Institutional Investors; in the United Kingdom, the Pro-Ned effort, which resembles the Gilson–Kraakman proposal for institutional directors.

3. Venture Capitalists

Venture capitalists acquire a substantial stake in a financed firm before it enters the public capital market. They shepherd financed firms through their period of early growth and profit by selling into the market after an initial public offering. The venture capitalist’s performance, like that of the actively managed mutual fund, depends on his spotting promising companies ahead of the market. Unlike the mutual-fund manager, the venture capitalist often participates actively in the affairs of the corporation, providing management advice, serving on the board, and introducing the firm to bankers, lawyers, customers, and suppliers.

Venture capitalists who sell as soon as a public market is available are not present as voters in the period of corporate life with which I am here concerned. Their relevance comes in the influence they exercise over the terms of the initial offering, including the corporate structure, charter, bylaws, and other legal devices then put in place. In preparing the firm for its initial offering, venture capitalists are guided by the way in which the market prices these legal structures during and after the offering. If the market prices all aspects of the corporate structure in a way that reflects their impact on shareholder wealth, then venture capitalists have a strong incentive to put in place shareholder-wealth-maximizing structures. But inefficiencies in the market for initial offerings often cause firms to launch with shareholder-wealth-reducing structures that are difficult to fix after the fact.

44. Gilson & Kraakman, supra note 11.
Politically driven investors are motivated by a need for the consent of others: election to a position is the paradigm. A well-functioning political system advances a view of the good arrived at by aggregating or otherwise resolving individual views of the good. It is constrained in doing so by the imperfect competence and loyalty of its controllers. Political forces push actors to develop characteristics not directly related to merit: reputation, a public record, or networking skill, for instance. Political forces operate best on actors insulated from market forces. If market competition makes every act necessary, political forces have no room in which to move the actor. Insulation from market forces is sometimes desirable because political ends encompass more than the utility maximization of markets. Similarly, agency problems between political institutions and their controllers can be desirable if controllers’ private preferences are preferable, perhaps temporarily, to institutional ends—the Senate as bulwark against popular fury or the Lords as check against the Commons.

The degree to which politically driven investors and their controllers have incentives that diverge from shareholder wealth maximization depends on the political processes in place and the distribution of individual views in the community. I do not constrain these factors in any way, except to observe that the outcome of a plausible political process is not likely to be wealth maximization alone. The differences between politically driven institutions that I explore relate to the degree and method of insulation from market and social forces that they provide, not the purpose of that insulation.

I. State

The principal paradigm of a politically driven institution is the state. We get some sense of states’ interests by looking at their direct regulation of corporations: bans on narcotics, the provision of trained assassins to private parties, and the destruction of rainforests, Eskimo homelands, and pretty seashores, for example. Political forces drive divergences from shareholder wealth maximization at the institutional level because political ideals encompass more than maximizing financial results. At the individual level, whatever a state’s objective function, its controllers are likely to be imperfectly competent and imperfectly loyal.

Political processes justify law. And these processes yield ends for law other than wealth maximization. The set of these ends and their relative weights as determined by


47. On the notion of a state’s objective function with respect to legal analysis, see, e.g., Camara, supra note 32, at Part VI.E. (explaining that a state’s objective function depends positively and exclusively on the welfare of its citizens and that a state’s objective function depends on the interests, occupations, and other characteristics of its citizens).

the political processes in place constitute the ends justifying domestic law, which law-appliers are duty-bound to advance. Very different individual conceptions of what these ends should be arise from moral philosophy, theology, or, more frequently, from inherited traits, education, ambient culture, and social indoctrination. At its best, politics reconciles the different conceptions of the good held by the members of a political community. At a minimum, politics is the way in which a political community gets past such conflicts and on to the everyday business of civil cooperation. A distribution of views about the good like that in the United States or the United Kingdom results under most sets of political processes (certainly democratic ones) in outcomes that deviate from shareholder wealth maximization. The influence of people unwilling to permit academic argument to sway them too far from common sense (and the political operatives who pursue their votes) only exacerbates this divergence.

and Normativity] (claiming that an emphasis on economic efficiency in legal analysis engenders false beliefs about the extant of law); C. Edwin Baker, The Ideology of the Economic Analysis of Law, 5 PHILO. & PUB. AFF. 3, 4 (1975) (arguing that Posner’s economic methodology is an “objectionable basis for policy guidance”); AMARTYA SEN, RATIONALITY AND FREEDOM (2002) (discussing the concepts of rationality and freedom as a basic idea in economics). Even the leaders of normative law and economics have abandoned, if they ever espoused, the claim that wealth maximization ought to be the social objective. Their present claim is that society should maximize some function that depends only on the subjective welfare of the relevant entities. See LOUIS KAPLOW & STEVEN SHAVELL, FAIRNESS VERSUS WELFARE (2002) (arguing that “social decisions should be based exclusively on their effects on the welfare of individuals” Id. at xvii.). Such a theory leaves open the question of how to determine what entities are relevant (Citizens? Residents? Everyone everywhere? Animals? Sentient computers?), and leaves one wondering what is so bad about agreeing not to maximize subjective welfare. It is not surprising that the pursuit of something other than maximum subjective welfare entails a willingness to sacrifice the subjective welfare of everyone for a sufficiently preferred increase along other dimensions of the good. See SEN, supra. The acceptance of the maximization of subjective welfare as a social end requires the analyst to forego the possibility of his arriving at, through reasoned reflection, meditative insight, divine revelation, or some other process at least a partial conception of the good invariant with respect to transformations of the relevant entities’ beliefs about the good—an at least semiobjective good. See ROBERT NOZICK, INVARIANCES (2002) (discussing the notion of invariance under transformations). The best reason we are given for doing this is that analysts have so far failed to arrive at a comprehensive consensus on semiobjective social goods. That the problem is difficult, however, is no reason to give up—we should remember the prize if we are successful: a theory of the good.

49. See Camara, supra note 32, at Part V.I.E.

51. Political philosophy is thus the study of how to do this well. See, e.g., JOHN RAWLS, POLITICAL LIBERALISM (1993) (addressing how consensus can be reached in a society that allows for a wide range of political and philosophical views).

52. See, e.g., Richard A. Posner, The Problematics of Moral and Legal Theory, 111 HARV. L. REV. 1637 (1998) (noting the inability of academic exponents of moral philosophy to convince the general public to act on their conclusions without intermediate politicking, which requires very different skills). But see, e.g., Ronald
Institutional objectives, however, determine state behavior only insofar as they are carried out by imperfectly competent and loyal officials. These officials’ interests are affected by their compensation, tenure, and exit opportunities. If these are not perfectly aligned with state objectives, then state behavior will diverge from those objectives to the extent officials are not constrained by other control mechanisms. When the private sector generally offers more attractive opportunities, state offices will attract those who particularly enjoy exercising their attendant prerogatives. This favors the pursuit of institutional objectives if what attracts officers is a unique opportunity to further those objectives, but cuts the other way if what attracts them is the opportunity to exercise state prerogatives for personal purposes.

Consider the paradigmatic civil servant. His compensation is tied more closely to tenure than merit, or is set by law at some nominal amount. He enjoys wielding power over others, for noble reasons, hopefully, and so pursues regular increases in budget and jurisdiction. If elected, his tenure depends on convincing a rationally uninformed and apathetic pool of voters preoccupied with matters of more immediate urgency. Should he seek appointment or election elsewhere in the state, his primary assets will be recognition, publicity, and contacts, rather than skill. Many outside opportunities are awarded on the same basis—positions at lobbying firms, government relations departments, and the less academic parts of academia, for example. The reputation that matters to these authorities may be more sensitive to failure than success and to individually attributable outcomes than behind-the-scenes work. This inclines the official toward conservatism and ceremonial formalism.

The political forces acting on the state are the sum of the ideals that emerge from the political processes in place (the political aggregate of the philosophical, theological, cultural, and common-sense visions of the good on which politics operates) and the bureaucratic and electoral concerns of state officials. Political forces affect state behavior because insulation mechanisms allow things other than financial performance to become important. Market competition does not often eliminate states. Even in the absence of direct ownership, a state’s tax laws give it a financial interest in corporate profits: it can tax corporations directly or the wealth they generate. A state can safeguard that interest through direct regulation of corporate conduct. Shareholder initiative may nonetheless increase a state’s ability to affect corporate conduct if using shareholder initiative is easier than issuing direct legal mandates as a matter of the operative political forces—if it is politically cheaper.

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53. E.g., “The Senators and Representatives shall receive a compensation for their services, to be ascertained by law, and paid out of the treasury of the United States.” U.S. CONST. art. I, § 6, cl. 1. “The President shall, at stated times, receive for his services, a compensation, which shall neither be increased nor diminished during the period for which he shall have been elected, and he shall not receive within that period any other emolument from the United States, or any of them.” U.S. CONST. art. II, § 1, cl. 6. “The judges, both of the supreme and inferior courts, shall hold their offices during good behaviour, and shall, at stated times, receive for their services, a compensation, which shall not be diminished during their continuance in office.” U.S. CONST. art. III, § 1.
In a democracy like ours, voting shares is likely to be a less salient event than direct regulation. Shareholder initiative gives states an extra means of camouflaging their business regulation. Because most votes can be defended plausibly as maximizing shareholder wealth, it is possible for the state to systematically camouflage its intervention on behalf of other interests (its expropriation of capital) by purporting to make voting decisions solely on this basis. We should expect interest-group competition over the exercise of shareholder initiative, just as we see such competition over, for instance, the interpretive comments in legislative committee reports. State ownership is another mechanism through which successful political operatives can intervene in economic affairs.

2. Public Pension Funds

Public pension funds are pools of capital collected by the state and invested on behalf of state employees. The public pension fund structure provides more insulation from political forces that favor things other than shareholder wealth maximization than does direct state ownership. Different fund structures provide different levels of insulation. A directly elected controlling board is more sensitive to political forces than a controller appointed for a long, unrenewable term and subject to removal only for cause carefully shown. The tradeoff is between insulation from political forces and accountability (including accountability for maximizing shareholder wealth) to the electorate or other fund beneficiaries.

Although public pension funds pursue non-shareholder-wealth-maximizing agendas less often than states investing directly likely would, they are among the leaders in corporate-governance activism. This activism includes but is not limited to issues widely thought to be principally of concern to shareholders: effective staggered boards, poison pills, and other devices in the literature on the market for corporate control. Public pension funds have often taken the lead on social-responsibility issues such as environmental protection, workers’ rights, and human rights in foreign regimes. While the public pension fund structure may dampen political pressures, it does not eliminate them entirely.

3. Shareholders with a Cause

The state and public pension funds are both examples of state actors principally driven by political forces. Nevertheless, political forces also can apply to institutions normally thought of as private. The “shareholder with a cause” is a person, perhaps with

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55. Proposals to increase the input of ERISA plan beneficiaries into voting decisions, see, e.g., Richard M. Buxbaum, Institutional Owners and Corporate Managers: A Comparative Perspective, 57 BROOK. L. REV. 1, 46–50 (1991) (discussing the relative insulation provided by different internal decision-making structures), would increase the impact of political forces on the voting decisions of corporate pension plans. This same structure of insulation versus accountability characterizes all delegations of state power, for example those involved in the ordinary institutions of private property and freedom of contract. See Morris R. Cohen, Property and Sovereignty, 13 CORNELL L.Q. 8 (1927).

56. See, e.g., Barnard, The New Corporate Governance, supra note 11, at 1144-47 (noting CalPERS support of the Valdez environmental responsibility proposals).
nominal ownership only, who seeks to influence shareholders by political means. Robert Monks is no doubt the most famous specimen, at least in the corporate-law literature. Donald Schwartz, who was counsel to Campaign GM, and Ralph Nader have at times fallen into this category. The shareholder with a cause acquires his views either by active reflection or through the more normal processes of socialization, education, and indoctrination. If his views diverge from shareholder wealth maximization then his application of political pressure may induce shareholder-wealth-reducing voting behavior. This is the objective of any number of socially oriented shareholder campaigns, although many of these, such as the election of minority directors, are likely to have no impact on corporate operations.

D. Socially Driven Investors

Socially driven investors are insulated from market and political forces by some combination of wealth, social position, training, and disposition. Market forces do not operate on them because they are either sufficiently wealthy or sufficiently indifferent to wealth that fluctuations in the values of their portfolios do not matter very much. Political forces do not operate on them because their positions are secure against attack from the outside. They have no need for elections, appointments, or political favors. They either have all they want or can cause others to provide it. They are “free.”

Social forces shape their actions in the presence of this market and political insulation. These forces include genetics; education and social pressure during the formative years; study and reflection in theology, moral philosophy, social science, history, and the affairs of the day; and cultural norms absorbed by immersion in a particular sociological setting. Unlike market and politically driven investors, socially driven investors vote according to the internal forces of psychology, albeit a psychology in large part shaped by external accident. Socially driven investors differ in the degree to which they enjoy such insulation, but most remain somewhat sensitive to market and political forces.

1. The Gentleman of Affairs

The principal paradigm of the socially driven institution is the gentleman of affairs. Here is the man who has come into substantial shareownership solely by virtue of his position in society. Of the three paradigmatic institutions, he is the freest. Although the value of his shareholdings moves with the performance of the firm, these fluctuations have little impact on him. He is wealthy enough that a wide range of fluctuations leave the amount of wealth he cares about untouched. His social position, the occupation of his time, is not dependent on the performance of his shareholdings. He is largely immune from political forces because he has little need for the uncompensated consent of others. For him, the questions of political cooperation seldom arise. Unlike the politician or state agent, his position or influence does not depend on bureaucratic or electoral

57. Campaign GM, or the Campaign to Make General Motors Responsible, was an effort by public minded shareholders to create and fill three new directorships with public interest directors. Donald E. Schwartz, The Public-Interest Proxy Contest: Reflections on Campaign GM, 69 Mich. L. Rev. 419 (1971).
58. See, e.g., id.
Instead, the gentleman of affairs is moved by the internal incentives of psychology, by his personal vision of the good. This is shaped partly by his active theological or philosophical reflection, and partly by the genetic, cultural, social, and educational pressures applied to him during his formative years. Wealth maximization is for many men one component of a personal vision of the good. The pursuit of wealth is generally tempered, however, by other concerns: the preservation of a family name; a distaste for overt involvement in industry or finance; reflectively and/or reflexively given support for certain causes; a sense of obligation to dependents, including other corporate constituents; a taste for intellectual integrity coupled with philosophical commitments arrived at after study; mores internalized through immersion in a particular social set; and a general desire to donate to the public life of the community—a sense of citizenship or noblesse oblige.

2. Founding Families and Plutocrats

Entrepreneurs and their heirs are one type of socially driven investor. Having

59. Would he not make an excellent candidate for admission to the bar?

60. See generally Abraham H. Maslow, A Theory of Human Motivation, 50 PSYCH. REV. 370 (1943) (setting out his famous hierarchy of motivating needs: physiological needs, security, love, esteem, and self-actualization). Although the use of psychological data in place of (what is perceived to be) more rigorous economic analysis has something like the credibility of voodoo in corporate law scholarship, there does exist a significant earlier literature drawing on psychology to contest the claims that incentive compensation can improve managerial behavior. Several commentators apply Maslow’s hierarchy of needs to argue that affection, esteem and self-actualization must be used to effectively motivate managers. See, e.g., K.R. SRINIVASA MURTHY, CORPORATE STRATEGY AND TOP EXECUTIVE COMPENSATION ch. 2 (1997); Douglas M. McGregor, The Human Side of Enterprise, in ADVENTURES IN THOUGHT AND ACTION: PROCEEDINGS OF THE FIFTH ANNUAL CONVOCATION OF THE SCHOOL OF INDUSTRIAL MANAGEMENT, MASSACHUSETTS INSTITUTE OF TECHNOLOGY 23 (1957); C.H. GREENEWALT, THE UNCOMMON MAN (1959) (noting that strong internal motivations may make external incentives unnecessary); C.B. RANDALL, THE EXECUTIVE IN TRANSITION 26 (1967) (claiming that internal satisfaction rather than money motivates executives); O. ELLIOTT, MEN AT THE TOP (1959) (same); DAVID C. MCCLELLAND ET AL., THE ACHIEVEMENT MOTIVE (1953) (describing achievement as motivator); Frederick Herzberg, One More Time: How Do You Motivate Employees?, HARV. BUS. REV. (Jan.–Feb. 1968) (arguing that money is preconditions to successful motivation, but achievement, recognition and self-actualization are also required).

amassed a sufficient fortune through military, industrial, financial, or professional affairs, the successful entrepreneur wins immunity from the market and political forces to which he was once subject. Often he will feel a connection to the firm he built up and to its various components—for example, long-term employees or sites important in the firm’s history. He may use his newfound social and financial position to advance causes of interest to him independent of his business affairs. He may launch a foundation or direct the charitable contributions of his firm to areas of personal interest. As the founding generation passes away, there come generations who inherit wealth and social standing through no effort of their own: born gentlemen, aristocrats, plutocrats. Their interests are further removed from corporate operations, and further controlled by education, social mores, and the like. A particularly common component of their imbibed psychology is a notion of reciprocal dominance and subjectivity, which imputes moral or ethical obligations to the founder or plutocrat on behalf of those still bound by market and political forces subject to manipulation by the firm—an English morality.

The degree of divergence between social forces and shareholder wealth maximization is historically contingent. Understanding it in any particular setting requires either a partial genealogy of morals, or, at least, a present understanding of non-market preferences of the sort studied by psychologists, behavioral economists, and neuroeconomists. Even the lean-back-and-ponder law-school method of empirics, however, is sufficient to confirm the possibility and likelihood of market and political insulation and the likely divergence of incentives created principally by social forces from wealth maximization.

3. Wealthy Managers and Technocrats

Wealthy managers are those employed by plutocrats to manage their industrial affairs once the latter no longer have the skill or interest to do so themselves. In the United States, they are the chief executives and those in the pool of potential chief executives. Their compensation and the respect they enjoy is sufficient to protect them from run-of-the-mill market and political forces, particularly toward the end of their careers. Nevertheless, their employment and reputation remain contingent on performance. Their standing is still characterized by a central relationship of subjectivity to the owners who wield ultimate control. When this subjectivity is overthrown, there rises a class of former managers who find themselves suddenly at the top of the heap, freed of any external—ownership check: technocrats. An older tradition in corporate law pinned its hope for social responsibility on technocratic managers exercising corporate powers for the general welfare. These managers were to be platonic guardians of the nation’s industrial power, subject only to occasional democratic restraint through the trumping
power of state institutions. Enhancing their influence over corporate affairs by augmenting their voting power is one way of pursuing this managerialist vision.

E. Multilateral Investors

Multilateral investors have a variety of financial relationships with the firm. If the payoffs associated with these relationships are different from those associated with equity ownership, these multilateral investors will sometimes not want to maximize shareholder value. The most popular legal response to multilateral investors has been to mandate separation of the parts of the multilateral investor dealing with each financial relationship. The object is to ensure that the control rights associated with each financial relationship are used to maximize the value of that relationship, not to augment the rights associated with other relationships. The tradeoff in mandating separation is between economies of scale and conflicts of interest.

1. Private Pension Funds

Private pension funds are those associated with private organizations, principally unions and corporations. Union pension funds pool capital from union members for investment while corporate pension funds pool capital from employees. Pooled capital is invested either directly or through a mutual fund or other engaged investment advisor. Voting rights are exercised by the investment advisor, fund officials, or management of the sponsoring organization. The Employee Retirement Income Security Act (ERISA) requires that votes be cast and that voting power be used to benefit plan beneficiaries, rather than the sponsoring organization. For example, it violates ERISA for a corporate pension fund knowingly to vote for an act designed to preserve managerial perquisites at the expense of shareholder value. But because almost all votes can be plausibly defended, the effect of ERISA is mainly in shaping managerial norms, mandating a veneer of

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investigation, and deterring the worst excesses by threat of liability. See supra, note 55, at 50 (arguing that the monitoring provided by ERISA only prevents “flagrant abuses”).

70 A duty of care claim requires a showing of gross recklessness. See Rabkin v. Hunt Chem. Corp., 547 A.2d 963, 970 (Del. Ch. 1986) (citing Allaun v. Consolidated Oil Co., 147 A. 257 (Del. Ch. 1929); Gimbel v. Signal Companies, Inc., 316 A.2d 599 (Del. Ch. 1974)). This is a consequence of the business judgment rule, which recognizes judges’ lack of business expertise, their affliction by hindsight bias, and directors’ being poor bearers of litigation risk. See, e.g., William T. Allen et al., Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of Van Gorkom and its Progeny as a Standard of Review Problem, 96 NW. U. L. REV. 449, 451-52 (2002) (contending that the Delaware Supreme Court wrongfully extended the duty of care to ordinary negligence in Smith v. Van Gorkom, but stating that normally the duty of care in corporate law only applies to gross negligence); Cooter & Eisenberg, supra note 68, at 464-66. Insurance is a partial answer to the concern that directors are poor bearers of litigation risk, that is, are risk averse with respect to litigation. As most insurance policies do not cover harm to directors’ reputations, however, and as these are likely to be damaged by a successful suit, the concern remains a real one. “[E]ven trial judges with guaranteed tenure are concerned that their decisions will be reversed on appeal. It is commonsensical to think that directors of public companies will likewise be disquieted at the prospect of reading in the Wall Street Journal that a court has enjoined their actions as imprudent.” William T. Allen et al., supra, at n.10. On hindsight bias, see, e.g., Brehm v. Eisner, 746 A.2d 244, 260 (Del. 2000) (quoting In Re The Walt Disney Co. Derivative Litig., 731 A.2d at 361-62) (noting that the court will not second-guess a board with the benefit of perfect hindsight); see generally Jeffrey J. Rachlinski, A Positive Psychological Theory of Judging in Hindsight, in BEHAVIORAL LAW & ECONOMICS 95, 109-110 (Cass R. Sunstein ed., 2000) (citing the business judgment rule as a judicial response to hindsight bias). Professor Oliver Hart has suggested an
Union pension funds, which have been among the largest supporters of the recent proposals to increase shareholder power, are concerned not only with maximizing shareholder value, but also with the employment contracts and working conditions available to member employees.\textsuperscript{71} Union pension funds might view favorably, for example, a corporate act, say, a larger employee benefits package, that decreases shareholder wealth but increases the wealth of employees (an expropriation of capital for the benefit of labor). Under a legal regime in which union pension funds, in concert with other institutions, can command such acts, contracting difficulties might prevent their being blocked even if the act decreases the total wealth available for distribution. Even if these contracting difficulties can be overcome, to grant such a power is to effect a distribution to employees, not to create a new control mechanism for shareholder wealth maximization.\textsuperscript{72} We might think of it as a mandatory, across-the-board increase in wages.

Corporate pension funds are concerned not only with maximizing shareholder value, but also with all those things with which corporate management is concerned. For example, corporate pension funds can be expected to prefer managerial insulation from the market for corporate control, large managerial compensation packages, costly acquisitions over which managers will then enjoy control, and so forth. Sympathy, understanding, and reciprocal voting encourage this concern when the shares a corporate pension fund votes are those of an unrelated corporation. Senior management feels enough of a connection and has enough hope of reciprocation to look out for other members of the group.

2. Bank Trust Departments

Bank trust departments invest funds as trustees for private or charitable trusts. When the same bank is a creditor of a portfolio company, the bank is interested not only in what is beneficial to shareholders, but also what affects the value of the debt it holds. The conflicts of interest between debt and equity are well known.\textsuperscript{73} Essentially, some of the risk of projects is borne by debt rather than equity holders because, below the point of insolvency, equity holders that enjoy limited liability have nothing to lose. Any secondary relationships that a bank might have with a portfolio company—consulting

\textsuperscript{71} Even under the current regime, union funds have attempted to use shareholder powers to extract labor benefits. \textit{See, e.g.}, Paul Sweeney, \textit{Clash by Proxy: Organized Labor and Shareholder Activism}, ACROSS THE BOARD, May 1966, Vol. 33, No. 5, p. 21, cited in Coffee, supra note 1 (discussing the role and effect of unions on management).

\textsuperscript{72} \textit{See The SEC’s Too Special Access}, WALL ST. J., Aug. 5, 2004, at A10 (editorial) (discussing the direct access proposal giving shareholders of 5\% ownership the ability to help determine the make-up of corporate boards).

\textsuperscript{73} \textit{See Smith & Warner}, supra note 34 (providing an excellent survey of the conflicts of interest between debt and equity and the legal responses thereto).
and investment banking relationships, for instance—poses this sort of problem. Although legal rules such as those already described can prohibit collusion of trust departments and other sections of a bank, it is generally recognized that their execution relies for the most part on the good faith of private parties.

3. Insurers

Insurers are significant holders of corporate debt, in part because debt is favored by the rules governing the risk level of investments relative to expected liabilities that insurers may maintain. Relative to the customers of bank trust departments, customers of insurance companies are less demanding with respect to investment performance. Insurance is fundamentally about guaranteeing rather than profiting and certainly is perceived this way by the public in spite of financial wizardry to the contrary. Conflicted insurers, having one weaker control mechanism in favor of shareholder wealth maximization, are therefore even more likely than conflicted bank trust departments to favor their debt over their equity holdings.

IV. INSTITUTIONAL INVESTORS AND SHAREHOLDER VOTING

The preceding classification of institutional investors reveals that they and their controllers often have sectional interests that conflict with shareholder wealth maximization. At least in the United States and the United Kingdom, however, institutions are numerous and diverse, and their holdings, while large, are not individually controlling. Consequently, institutional investors must work together to exercise corporate control. Proponents of shareholder initiative contend that, while each institution has sectional interests, because institutions’ only common interest is in increasing shareholder wealth, only shareholder-wealth-increasing proposals will obtain majority support. Subpart A demonstrates that this contention is unpersuasive because a majority may well support a proposal that sufficiently advances sufficiently many sectional interests even though it reduces shareholder wealth.

This establishes that effective shareholder voting cannot be justified as increasing shareholder wealth. It might yet be justified, however, by some other corporate law end. Subpart B uses the frequently drawn comparison between corporate and political democracy to identify the corporate-law ends that might justify effective shareholder voting. Subpart C then takes up the question whether any of these ends would be desirable for corporate law. Subpart C.1 examines shareholder wealth maximization, the corporate-law end that dominates the corporate-law literature, and concludes that this end is inadequately justified. Subpart C.2 offers three alternative ends for corporate law, each of which might justify effective shareholder voting. The desirability of shareholder initiative turns on the desirability of these alternative ends.

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74. It is important to distinguish between the value of holdings in portfolio companies and the value of shares in the institutional investors since maximization of the latter value may involve abandoning rather than improving a portfolio company. It is important to distinguish between the market value of shares in portfolio companies and the market value of the institutional investor’s shares since these may carry a substantial control premium.
A. Majority Voting as a Check on Sectional Interests

Consider a group that decides to resolve a set of independent issues by majority vote. In a voting outcome each issue is adopted or not and each voter has a preference, positive or negative, with a certain magnitude, for the approval of each issue. A voter’s payoff is the sum of his preferences for all issues adopted in an outcome. The choice set is the set of possible voting outcomes (the set of outcomes such that for each outcome there is another outcome in the set that a majority of voters prefer to the first outcome). In the case of a set with one member, a single outcome is majority preferred; in sets with more than one member, there is a voting cycle.

Supporters of shareholder initiative claim that the majority-voting rule will prevent this group from adopting any minority-preferred issues. The concurrence claim is intuitively appealing because it seems that a majority would always favor moving from an outcome that fails to include adoption of a majority-preferred issue to an outcome that does include adoption of that issue, and would never favor moving in the opposite direction. But we are not justified in saying this about an issue merely because it is majority preferred. We also need information about the relative strength of voters’ preferences for that issue as against other issues being decided.

Voters decide to vote for a move from one outcome to another based on the total impact of all changes made in the move. The majority-voting rule ensures that this sum is positive for a majority of voters. However, this can be so even if some or all of the individual issues are negatively preferred by a majority of voters. A majority might give up issues it prefers or adopt issues it does not if the impact of other adopted issues on its members’ payoffs is positive and sufficiently large. Think, for example, of increased defense spending in a senator’s state in exchange for his vote to confirm a judicial nominee. Minority-preferred issues are bundled such that adoption of the set is majority preferred.

Contract law provides an illustrative comparison. The adoption of issues by contract generally requires unanimity. Nevertheless, minority-preferred issues can be and regularly are adopted when suitably grouped. Consider a sale—only the seller prefers that the buyer pay the price, and only the buyer prefers that the seller deliver the goods. Neither proposition alone—that the buyer pay or the seller deliver—can receive the necessary unanimous vote, but the set of minority-preferred issues—that the buyer pay and the seller deliver—can command unanimous voting support. The resulting contract is not as good for the seller as one in which the only obligation is that the buyer pay, nor as good for the buyer as one in which the only obligation is that the seller deliver. Nevertheless both are better off than would be if neither obligation existed. Thus,

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75. So that we can think of a set of issues \{X, Y, \ldots\} and outcomes \{X, XY, XZ, \ldots\}.
76. On cyclical voting preferences, see H. SCOTT BIERMAN & LUI S FLORETIN FERNANDEZ, GAME THEORY WITH ECONOMIC APPLICATIONS 104-105 (2d ed. 1998). See generally KENNETH ARROW, SOCIAL CHOICE AND INDIVIDUAL VALUES, 2-3, passim (1951) (discussing the impact of individual value judgments on collective social choice); JAMES M. BUCHANAN & GORDON TULLOCK, THE CALCULUS OF CONSENT: LOCAL FOUNDATIONS OF CONSTITUTIONAL DEMOCRACY (1962) (stating that collective human activity selects the most efficient of possible choices); ANTHONY DOWNS, AN ECONOMIC THEORY OF DEMOCRACY 60-61, passim (1957) (analyzing how alternatives to choices made by government can be capitalized upon by the opposition where there exits voter disagreement). For a corporate law application relevant to this Article, see Gordon, supra note 1.
both are willing to vote for the minority-preferred issue favored by the other party. The essential point is that mere majority preference does not provide enough information to support a claim about adoption under a majority-voting rule. A further numerical and symbolic discussion appears in the margin.

77. Consider a group of shareholders of three equally numerous types. The first type consists of hedge funds exclusively concerned with maximizing shareholder value (type "A"). The second type consists of direct state ownership and public pension fund holdings (type "B"). Type B shareholders are interested in increasing shareholder wealth, but they are also interested, because of upcoming congressional elections, in saving the sea lion. The third type of institutional investor consists of the heirs of the firm’s founder who, although they like money, also feel a special attachment to the location of the firm’s first major manufacturing plant in Templeton, North Dakota (type “C”). Armed with an intervention power, these shareholders face three issues: first, whether to (elect directors who will) accept a value increasing acquisition offer (issue “X”); second, whether to (elect directors who will) save the sea lion by contributing to Save the Sea Lions, Inc. (issue “Y”); and third, whether to (elect directors who will) keep the plant in Templeton (issue “Z”). Adoption of issue X is shareholder wealth maximizing, while adoption of Y or Z is not. The shareholders’ preferences as to issues appear in Figure 1, and their preferences as to outcomes appear in Figure 2. “Ø” represents the status quo outcome. (The situation where the preference of shareholders for one shareholder wealth maximizing issue, here X, depends on the resolution of non-shareholder wealth maximizing issues, here Y and Z, by incorporating the effect of adoption in shareholders’ preferences for the non-shareholder wealth maximizing issues.)

Figure One: Shareholder Preferences as to Issues

<table>
<thead>
<tr>
<th>Shareholders</th>
<th>X</th>
<th>Y</th>
<th>Z</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>1</td>
<td>-1</td>
<td>-1</td>
</tr>
<tr>
<td>B</td>
<td>1</td>
<td>2</td>
<td>-1</td>
</tr>
<tr>
<td>C</td>
<td>1</td>
<td>-1</td>
<td>2</td>
</tr>
</tbody>
</table>

Figure Two: Shareholder Preferences as to Outcomes

<table>
<thead>
<tr>
<th>Shareholders</th>
<th>A</th>
<th>B</th>
<th>C</th>
</tr>
</thead>
<tbody>
<tr>
<td>X</td>
<td>XY</td>
<td>XY</td>
<td>XZ</td>
</tr>
<tr>
<td>XY, XZ, Ø</td>
<td>XYZ, Y</td>
<td>XYZ, Z</td>
<td></td>
</tr>
<tr>
<td>XYZ, Y, Z</td>
<td>YZ, X</td>
<td>YZ, X</td>
<td></td>
</tr>
<tr>
<td>YZ</td>
<td>XZ, Ø</td>
<td>XY, Ø</td>
<td></td>
</tr>
<tr>
<td>Least Preferred</td>
<td>Z</td>
<td>Y</td>
<td></td>
</tr>
</tbody>
</table>

Observe that from the status quo, there exist majorities to move to X (shareholders A, B and C), YZ and XYZ (B and C). From YZ, there exist majorities to move to XYZ (A, B and C), XY, Y (A and B), XZ and Z (A and C). From Y, there exist majorities to move to XY (A, B and C), XZ and X (A and C). From Z, there exist majorities to move to XZ (A, B and C), XY and X (A and B). Thus, from all outcomes for which there are majorities there exist majorities to move to outcomes including the adoption of X. From X, there is a majority to move to XYZ (B and C). From XYZ, there exist majorities to move to XY (A and B) and XZ (A and C). From XY there is a majority to move to X (A and C), and from XZ there is a majority to move to X (A and B). Thus, X, XY, XZ and XYZ form the choice set. The choice set includes outcomes where minority preferred issues (Y and Z) are adopted. This disproves the strong version of the concurrence claim. It also includes outcomes that fail to include majority preferred issues (!Y and !Z), and so disproves the weak version of the concurrence claim (by the collapsing argument).

To make it plain that not all outcomes in the choice set need include a majority preferred issue simply conceived (that is, before application of the collapsing argument), consider a variation on the story. Instead of being hedge funds, type A investors are union pension funds and the shareholder wealth maximizing issue X...
The reasoning and results can also be expressed symbolically. Let \( V = \{V_1, \ldots, V_n\} \) represent the set of outcomes. \( P = \{P_1, \ldots, P_m\} \) represent the preferences of voters 1 through \( n \) over issues 1 through \( m \); \( x \in \{1, \ldots, m\} \) index an issue; and \( O = \{O_1, \{0, 1\}, \ldots, O_n \in \{0, 1\}\} \) be the form of outcomes. Then \( \pi(V, O) = \sum_{i=1}^{m} \) is the preference relation for a voter over outcomes; and \( \mu(O_1, O_2) = (\Phi(V, O_1, O_2) \text{ is the preference relation over a voter over outcomes; and } \mu(O_1, O_2) = (\Phi(V, O_1, O_2)) \text{ for } \forall i \in \{1, \ldots, m\} \text{ and } O_1 \in \{0, 1\} \text{ is the majority preference relation over outcomes. An outcome } O \text{ is in the choice set if } \exists \omega \in \{O_1, \ldots, O_n\}: (O \in \omega) \land (\forall i \in \{1, \ldots, r\}, \exists j \in \{1, \ldots, r\}: \mu(O, O_j). (That is, if and only if there exists a set of outcomes such that the outcome in question is a member of the set and, for each member of the set, there exists a member of the set, possibly the same one, from which a majority prefers to move to the first member. I mean to include the case in which the choice set has only one element, in favor of moving from which there is not a majority.)

We want to disprove the (collapsed) concurrence claim. We can state the concurrence claim as \( \mu(x) \to \forall O \in \omega, O_1 = 1 \). To see what information is required to justify this inference, we can expand the right hand side using the definition of \( O \in \omega \) so that we have \( \mu(x) \to \forall O \in \omega) \land \forall O_1 \in \omega, \exists O_2 \in \omega: \mu(O_1, O_2) \land O_1 = 1 \). Similarly, using the definitions of \( \mu, \Phi \text{ and } \pi \) we have \( \mu(x) \to \forall O \in \omega \forall O_1 \in \omega, \exists O_2 \in \omega: \Phi(V, O_1, O_2) \text{ for } \forall i = \{1, \ldots, n\} \text{ and } O_1 = 1 \to \forall O \in \omega \exists O_1 \in \omega, \exists O_2 \in \omega: \pi(V, O_1, O_2) \text{ for } \forall i = \{1, \ldots, m\} \text{ and } \exists O_1 \in \omega, \exists O_2 \in \omega: \Sigma_{j=1}^{m} (P_j \cdot O_j) > \Sigma_{j=1}^{m} (P_j \cdot O_j) \text{ for } \forall i = \{1, \ldots, n\} \land O_1 = 0 \). We can disprove this by showing that it is possible that \( \mu(x) \land \exists O \in \omega \forall O \in \omega: \exists O_1 \in \omega, \exists O_2 \in \omega: \Sigma_{j=1}^{m} (P_j \cdot O_j) > \Sigma_{j=1}^{m} (P_j \cdot O_j) \text{ for } \forall i = \{1, \ldots, m\} \text{ and } \exists O_1 \in \omega, \exists O_2 \in \omega: \Sigma_{j=1}^{m} (P_j \cdot O_j) > \Sigma_{j=1}^{m} (P_j \cdot O_j) \text{ for } \forall i = \{1, \ldots, n\} \land O_1 = 0 \). That is, that in spite of \( x \) being majority preferred, there might exist an outcome that both fails to include adoption of \( x \) and is in the choice set. Notice that the middle condition depends on \( P_2 \), whereas the first condition constrains only \( P_0 \). But since the truth of the middle condition on condition \( O_1 = 0 \) depends on the relative preferences of voters for other aspects of \( O_1 \), \( \mu(x) \) is insufficiently constraining to assure the falsity of the middle condition. Or, stated otherwise, \( \mu(x) \) does not give us complete enough information about \( P_2 \), for all to rule out the middle condition. Because the concurrence claim purports to deduce the condudment of the first and the third, this lack of information is sufficient to disprove the concurrence claim.

78. See, e.g., Caplin, supra note 11 (discussing the influence of changes in corporate law on corporate democracy and proposing a model for nominating procedures for corporate directors).

79. There are stories suggesting that increased shareholder power is harmful in other areas as well. See, e.g., Ivo Welch, Sequential Sales, Learning, and Cascades, 47 J. Fin. 695, 712 n.20 (1992) (“While the context is different, this model suggests that shareholder democracy is not always in the best economic interest (even of shareholders.”).
context, means arguments take several forms. On one hand, voting can be analogized to contract: it is part of an institutional structure that harnesses private incentives in aid of the common good. On the other hand, voting can be analogized to debate: it is a source of information that helps decision-makers identify the social good. And even if voting does not lead to the right decision in each particular case, the errors it makes might balance out over a long series of decisions.

The contract- and debate-based means arguments are unpersuasive in the political context for the same reasons they are unpersuasive in the corporate context. Voters, rationally, are not good enough decision-makers. The balancing-out justification seems too fragile a base for political democracy because it depends on the relative weight of the factors that contribute to error, all of which are unstable: whether there is balancing out depends on the fluidity of coalitions; distribution of private interests around the social good; and relative strength of the backers of each set of private interests.

Ends justifications are thus more attractive than means arguments in the political context. Voting might be a part of self-actualization, necessary to make a person complete; constitute the expression of a high human excellence; or be an expression of solidarity with other voters or the beneficiaries of the voting arrangement. These arguments have less intuitive appeal in the corporate context, but, I think, only because of the dominance of shareholder wealth maximization in corporate-law scholarship. Shareholder voting is like voting in clubs and other private voluntary-membership organizations. There, voting is thought not only useful, but fair: desirable in itself. Part of the Western worldview is to want concentrations of power over things that individuals care about—money, intimacy, freedom, one’s principal private pursuits—to be subject, at least in name, to collective authority. Thus shareholder voting, like voting in clubs, might be justified because it is good to ask those principally affected what they think—good even if they answer rarely; when they do, have little intelligent to say; and know this. Closely related and more palatable to some is the means argument that justifies voting as satisfying tastes for voting.

Finally there are the dark justifications for voting: voting as a means of giving voters the illusion of control when, barring moments of popular explosion caused by elites’ miscalculation, it is the insert-your-favorite-elite (possibly beneficent) that exercises power. This is the type of story, in the political context, in which rational-basis review of economic and social violations of substantive due process is driven not by constitutional principle, but by the pragmatics of judicial authority: it is a saving of the judiciary’s social capital—its constitutional legitimacy—for interventions in democracy closer to the hearts of the bench. In corporate translation, shareholder voting is something

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81. The ease of finding such arguments reminds one of the ease of positing until-then-unexpected tastes to make a rational-actor model work. See Michelman, Norms and Normativity, supra note 48 (discussing ends justifications in the context of efficiency); Michelman, Uses and Abuses, supra note 48 (discussing ends justifications in the context of Posner’s wealth-maximizing theory of economic analysis).

82. Think of hostile takeovers in corporate law, which many have advocated as the best justification for shareholder voting.

83. Dean Pound wrote: “When the lawyer refuses to act intelligently, unintelligent application of the legislative steam-roller by the layman is the alternative.” Roscoe Pound, The Spirit of the Common Law xiv (1921).
managers point to when they want to say that shareholders are in control. Managers, they meekly remind us, can be ousted annually by the shareholders they serve. In dark stories, voting is a means of power preservation for a group other than the voters or the publicly acknowledged beneficiaries of voting. Dark stories seem more plausible in the political than in the corporate context.

C. Justifying Shareholder Voting

Voting’s justifications in the political context suggest two possible justifications for shareholder voting: as a means to something other than shareholder wealth; or as an end in itself. In corporate law, the capture of the voting process by large players with sectional interests might be desirable. Voting would then be a means not to shareholder wealth maximization, but to some other end. Corporations’ importance in daily life suggests they may properly serve as a focus for the interests in deliberative self-government that justify voting as an end in itself in the political context. This Subpart begins by examining shareholder wealth maximization as corporate law’s end. It then explores three alternatives.

1. Shareholder Wealth Maximization

Most of corporate law and the corporate-law literature assumes that directors should maximize shareholder wealth. No doubt this involves making some concessions to shareholders that are not contractually or otherwise legally required. Shareholders and stakeholders might not contract for mutually desirable concessions ahead of time because it is difficult to foresee the contingencies on which mutual desirability depends or specify them in such a way that their occurrence can be verified by the contract-enforcement system. Even absent these costs of contracting, stakeholders might prefer noncontractual commitment mechanisms—say, the operation of a trust norm.\(^84\) Those opposed to shareholder wealth maximization do not claim only that noncontractual concessions should sometimes be made; rather, they claim that such concessions should be made even when they reduce shareholder wealth.

One defense of shareholder wealth maximization can be disposed of at the outset. It is not sufficient to assert that shareholders own the corporation and consequently are entitled to loyal directors, subject only to external legal constraints. For whether the corporation belongs to shareholders exclusively is the question at issue. Ownership is as much a legal construct as is the duty of directors to maximize shareholder wealth.

Two other defenses of shareholder wealth maximization merit more extended consideration. First is the “dodge” defense, which claims that stakeholders would always prefer a legal rule requiring shareholder wealth maximization. Even though stakeholders will be able to expropriate capital periodically, the dodge defense holds, they would rather commit in advance not to take advantage of such opportunities in order to encourage capitalists to invest.\(^85\) Corporate law’s role, to the extent it mandates

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84. For a discussion with citations to the literature, see Camara, supra note 1, at Part I.A n.12.
85. See, e.g., Bayless Manning, Thinking Straight About Corporate Law Reform, 41 LAW & CONTEMP. PROBS. No.3, 20–23 (Summer 1977) (contending that shareholders have more to gain from maximizing efficiency than any other constituency of the enterprise); Beardsley Ruml, Corporate Management as a Locus of Power, 29 CHI.-KENT L. REV. 228, 242–43 (1951) (contending that expansion of representation on corporate
shareholder wealth maximization, is to enforce this hypothetical commitment by stakeholders.86

The dodge defense (so named because it dodges the problem of conflicts between stakeholder and shareholder interests by finding that they overlap perfectly ex ante) works only if markets are efficient. Consider a simple case with two players: employees (E), who supply labor and receive compensation (e); and shareholders (S), who supply capital and enjoy a share price (s). The corporation has the ability to take acts (A), which we can think of as contracts between employees and shareholders that affect compensation and share price, measured in units comparable 1:1, by amounts $e'' - e = \Delta e$ and $s'' - s = \Delta s$, respectively. Directors can retain any $\Delta e$ to directly increase share price. Under a shareholder-wealth-maximization rule, directors are obliged to take A if and only if $\Delta s$ exceeds $\Delta e$.

If $\Delta s$ is less than $\Delta e$, shareholders are paying $\Delta e$ and receiving less in return, which reduces shareholder wealth. If shareholders expect directors to take A even though $\Delta s$ is less than $\Delta e$, they can decline to provide capital to the corporation. They will do so if the cost of moving to the next-best investment opportunity (investing in $C''$ instead of C) is less than the cost of A, $\Delta e - \Delta s$. The cost of moving, $\Delta C$, includes the difference in returns provided by the next-best investment opportunity (zero if a $C''$ exists identical to C except with directors who do not take A), the transaction costs of switching investments (zero if it is just as easy to invest in $C''$ as in C, say, because both appear on the local broker’s menu), and the costs of becoming aware of the next-best investment opportunity (zero if there is perfect information about investment opportunities).

Nonzero costs of moving are an imperfection in the capital market. As between two situations, one with high, the other with low, costs of moving, the latter produces a more efficient allocation of capital. These imperfections take a variety of forms. The law may be such that advantages of an investment form, such as corporate status, are tied to the taking of A. The only way shareholders can escape A is by investing in a quite different enterprise. If the benefits of corporate form are great, either because of state-provided benefits (such as limited liability, swift courts, or asset partitioning), or because of private rational or irrational bias (network effects), then A can be quite harmful to shareholders without inducing them not to invest. This is the translation into modern corporate-law talk of the old and over-criticized argument that the state can condition the privilege of

boards to interested parties other than stockholders would significantly reduce business management efficiency); Eugene U. Rostow, To Whom and For What Ends is Corporate Management Responsible?, in THE CORPORATION IN MODERN SOCIETY 64 (Edward S. Mason, ed., 7th ed. 1970) (discussing whether corporate responsibility is primarily to shareholders or to the public interest); David L. Engel, An Approach to Corporate Social Responsibility, 32 STAN. L. REV. 1 (1979) (discussing whether corporations should pursue public interests that conflict with shareholders’ desire to maximize profit).

86. A default rule would be desirable if stakeholders were fully competent to understand the argument for this position. The default rule would overcome contracting problems, at a minimal cost to the autonomy values animating freedom of contract. Alternatively, if there is some small subset of corporations for which the argument does not hold, a default rule can be justified as facilitating value maximization for those corporations. This argument requires that stakeholders actually be able to take advantage of the opt-out option, overcoming any collective action problems in addition to the problem of understanding the desirability of the opt-out option. A mandatory or paternalistic rule would be desirable if stakeholders were not competent to understand the argument for this position. The mandatory rule would, in addition to overcoming normal contracting problems, avoid the need of the contracting mechanism for intelligent maximization of preference satisfaction.
the corporate form on corporate responsibility. Because the state has a monopoly on recognizing corporations, it can erect a limited-dimensional barrier to entry that supports those inefficiencies in corporate operation that it favors. The state can condition the corporate form on the acceptance of some expropriation. Indeed, the state might, because of technological limitations (the lack of perfect corporate control mechanisms) be unable to prevent a certain amount of expropriation. The costliness of information and information-processing capacity (including education) presents a similar obstacle to perfect information. When these sorts of market imperfections exist, directors can expropriate capital without inducing shareholders to invest elsewhere even if shareholders anticipate this expropriation ex ante. The dodge defense thus fails because, in these cases, the interests of shareholders and stakeholders are genuinely in conflict.

Similar stories can be told for imperfections in the markets pertaining to all other corporate inputs. Market inefficiencies create a surplus that directors can allocate between shareholders and stakeholders without causing any of them to withdraw their inputs. Because each group prefers a different distribution of this surplus, the dodge defense fails in the presence of market inefficiencies.

The second defense of shareholder wealth maximization is the “bigger-pie” defense. It claims that shareholders are the group for which it is easiest to design corporate control mechanisms. Consequently, forcing directors to maximize shareholder wealth generates the maximum corporate wealth—the biggest pie—possible. Getting the biggest pie might not be desirable in itself if, as a consequence, the pie were allocated in a bad way. But the social redistribution mechanism—income tax and spending programs, for example—can redistribute this wealth in a socially desirable way.

One can attack the proposition that shareholders are the cheapest locus of control rights. But I intend to pass that objection by, for another is stronger. Because the social redistribution mechanism is imperfect, shareholder wealth maximization is not desirable even if it leads to creation of the biggest pie. The greater profits produced by shareholder wealth maximization are allocated by law. The ordinary, liberal structure of contract and property, for instance, allocates profit to employees according to their bargaining power in private labor markets. That power can be supplemented by laws providing for unions, minimum wages, or mandatory benefits. Outright redistribution to the law’s special favorites can be achieved through the tax and welfare systems. If this distribution system achieves the good distribution more cheaply than would changes in corporate law rules, then shareholder wealth maximization is desirable despite its distributional effects, which can be undone later. The closer the good distribution is to that produced by the ordinary private-law rules plus shareholder wealth maximization, the less redistribution is necessary, and the more attractive this approach seems.

The trouble with the “bigger-pie” defense is that the existing social redistribution mechanisms do not perfectly achieve the good distribution on a wide range of views of the nature of that distribution. Actual redistributive mechanisms like the income tax are imperfect from the perspective of most views of the good because the political

87. This range can be further expanded by relaxing the implicit assumption that the cost of losing a particular set of suppliers of capital (S) or labor (E) exceeds the benefit to one group or the other by switching to a different supplier (S’ or E’) and picking a more favorable value distribution (higher or lower compensation, respectively).
mechanisms that generate redistribution are imperfect. Further, if the social good encompasses not only a good distribution, but also a means of achieving that distribution other than through wealth maximization plus redistribution, the failure to use that means is itself socially costly. Thus shareholder voting, despite reducing shareholder wealth, might be independently desirable. So long as redistribution is imperfect and process important, the bigger-pie defense is on shaky ground. There is no guarantee that maximization plus redistribution is better than a failure to maximize that involves a different process and has a different impact on distribution.

2. Three Alternatives

The dodge and bigger-pie defenses of shareholder wealth maximization rest on questionable assumptions about the efficiency of markets, the effectiveness of the social redistribution mechanism, and the value of process. These weaknesses of shareholder wealth maximization point the way to alternative ends for corporate law that might justify effective shareholder voting—and that might explain both the attachment of academics to shareholder voting and certain institutional investors’ recent support of shareholder initiative. Three categories of such ends present themselves: achievement of a good distribution of corporate profits (distribution), governance through inherently valuable corporate processes (process values), and compliance with non-corporate-law legal constraints (external constraints).

First, consider distribution as a corporate law end. Distributive outcomes may be better pursued through corporate-law rules than through the specialized social redistribution mechanism. If employees do not benefit sufficiently from this mechanism, one way to better the distribution of social wealth is to increase their bargaining power. This is done by increasing their property: by entitling them to things that they can then threaten to withhold. Shareholder initiative may increase the threat advantage of employees by equipping institutions that care about employees—union pension funds, for example—with valuable votes. These institutions can condition their willingness to participate in voting coalitions on the corporation’s providing benefits to employees: higher wages, better working conditions, less outsourcing, recognition of a union, etc. Moving this redistribution out of the public-law realm of the social redistribution mechanism into the private-law realm of corporate law, contract, and bargaining power camouflages the nature, magnitude, and existence of the redistribution achieved by a legal change—the move to shareholder initiative. The distributive effects of shareholder initiative depend on the non-shareholder-wealth interests of institutional investors. The strong support of union or public pension funds for shareholder initiative might indicate that they think it would increase shareholder wealth generally, but it might also indicate that they think shareholder initiative would allow them better to advance their sectional interests.

Second, consider process-value ends. Even if the social redistribution mechanism can perfectly achieve the good distribution, other aspects of the social good may make shareholder voting independently valuable. Modes of social organization are plausible carriers of value. The value attached to social modes of organization need not be connected to the welfare, objectively verifiable or otherwise, of any voter or beneficiary of voting. Process-value ends as justifications for shareholder initiative depend on what the social good is—on how voting relates to it. On a preference-satisfaction view of the
good, whether process-value ends justify shareholder initiative depends on people’s tastes for voting. Their voting practices shed light on those tastes. That people enjoy voting in other institutions that exercise power over important aspects of their lives—for example, their political regime (the state), important private civic or social organizations (party, club, church), or work (committees, feedback systems)—is evidence that they would enjoy voting in the corporate context as well. On a preference-satisfaction view of the good it is troubling that people’s preferences for voting are often based on an unrealistic conception of its effectiveness. Their preference may actually be for certain outcomes, and their view that voting is a good way of achieving those outcomes, objectively mistaken. Furthermore, they may project the success of voting in some areas (small committees) to other areas (the state or the large, public corporation) in which it is less likely to be effective.

Non-preference-satisfaction conceptions of the social good justify corporate law’s protection of process values when these conceptions give independent weight to the presence of shareholder voting. The persuasiveness of such conceptions turns on the appeal to the person making that judgment of the best moral-philosophical story that can be told on their behalf. In the current academic-political regime, moral-philosophical stories that emphasize forms of participatory control like voting are often found appealing. Absent a more objective standard for the quality of moral-philosophical stories, that is the best evidence that we have for non-preference-satisfaction conceptions of the good that might support shareholder initiative.

Third, consider external-constraint ends. As a doctrinal matter, directors are not obliged to violate the law in order to maximize shareholder wealth. In a suit to enforce the duty to maximize shareholder wealth, the illegality of what it is alleged the directors should have done is an absolute defense. This is so even if, taking into account the probability of detection and the magnitude of the penalty, the act would be desirable from the perspective of shareholder wealth maximization. Most commentators accept external legal constraints as appropriate, presumably because these constraints, even when misguided on a commentator’s personal view of the social good, arise from a legitimate political process.

If the organizational structure of the corporation, useful for many purposes, has the side effect of weakening some of the control mechanisms used by society to secure compliance with external legal constraints, then substitutes are desirable. Professor Einer Elhauge recently identified one of the ways in which this might be true. On this view,

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88. See, e.g., ROBERT A. DAHL, A PREFACE TO ECONOMIC DEMOCRACY (1985) (presenting an alternative to current corporate governance structures); Jon Elster, Self-Realization in Work and Politics: The Marxist Conception of the Good Life, in ALTERNATIVES TO CAPITALISM 127 (Jon Elster & Karl O. Moene eds., 1989) (arguing in favor of a principal of self-realization as opposed to consumption); CHARLES E. LINDBLOM, POLITICS AND MARKETS (1977) (describing the interplay between political and private governance).

89. See Einer R. Elhauge, Sacrificing Corporate Profits in the Public Interest, (2004) (working paper), available at http://www.law.harvard.edu/faculty/elhauge/pdf/sacrificing_corporate_profits.pdf (last visited Oct. 22, 2004). Professor Elhauge’s proposed remedy is to allow directors to consider stakeholder interests because directors are more subject than are shareholders to social and political forces. It is not clear how Elhauge concludes that this is the proper level of exposure to social and political forces. For example, we might increase the impact of those forces by forcing directors to attend sympathy training or to hold public town meetings or to include token representatives of stakeholders on the board. Further, it is not clear why the adaptive mechanisms that give rise to social and political forces would not be able to adjust themselves to the corporate form. Even if
control mechanisms for generally applicable legal constraints (external legal constraints from the corporate perspective) include a mix of legal sanctions, public enforcement, private pressure, and internalized preference. In the terms of our earlier taxonomy of institutional investors, control mechanisms for generally applicable legal constraints include not only market forces, but also political and social forces. Because corporate law provides insulation from political and social forces in order to facilitate the impact of market forces, it weakens or distorts the control mechanisms that rely on those forces.

Shareholder voting is a way of reducing the insulation of directors from political and social forces. Institutional investors are interested in things other than shareholder wealth. The political and social pressures that ordinarily cause people to care about these things may not have their normal impact on directors because of their insulation from political and social forces. For example, directors remote from a manufacturing firm’s day-to-day operations have little exposure to the plight of employees terminated as a result of downsizing. But a union pension fund with large holdings in the corporation can form coalitions with other institutional investors having outside interests to limit such downsizing. The union pension fund’s voting power is a substitute for the social and political forces that, absent the corporate structure, would affect directors’ actions. On this view, institutional shareholders take on the role with respect to large corporations that lobbyists and activist groups such as the National Rifle Association, American Civil Liberties Union, or indeed the unions behind some of the recent proposals for increased shareholder power themselves, already play in the public political sphere. Shareholder voting is a way of repoliticizing corporate law.

This view of shareholder voting as a control mechanism for external legal constraints emphasizes that the failure of states to place direct limits on corporate conduct through public enforcement and sanctions, that is, through market forces, is not evidence of a state’s intent to permit such conduct. There is no a priori reason why the most effective control mechanism for external legal constraints is public sanctions and enforcement rather than cooptation of directors by manipulation of governance entitlements. Market forces have no universal competitive advantage over political and social forces. While such an advantage surely exists in the corporate-law literature, in this

the extra insulation provided by the corporate form overwhelms the prior levels of social and political forces, why these forces do not just increase in response so that a new equilibrium is reached? A theory of the operation of social and political forces is necessary.

90. Some responses to the argument that states charter corporations conditionally on the exercise of restraint on their part in the pursuit of shareholder wealth maximization that appear in the corporate law and economics literature are to the contrary. For example, Professor Fischel writes:

The debate concerning whether the corporation is a creature of the state or the product of private contract is largely irrelevant to the issue of corporate social responsibility. Regardless of which way the corporation is viewed, the state is free to set limits on its actions . . . . But states have not done so nor have they made it unlawful to form corporations for profit. State chartering of corporations, therefore, in no way interferes with managers’ contractual duty to maximize wealth of investors.

Daniel R. Fischel, The Corporate Governance Movement, 35 Vand. L. Rev. 1259, 1274 (1982). Arguments such as this miss the point since the question up for consideration is whether corporate law ought to limit the pursuit of shareholder wealth maximization. The only way to read it as a response to that question is as holding that the absence of express legal constraint constitutes legal permission. But if the body of legal constraint includes not only express constraint but also the (extra-legal? Or merely extra-market?) operation of social and political forces, then the equivalence does not hold.
the literature does not reflect practice. The prevalence and public appeal of statements of purpose, ethical policies, mission statements, and other such mainly verbal commitments testify to the widespread perception that social and political forces can be effective control mechanisms in their own right.

V. CONCLUSION

Effective shareholder voting cannot be justified as increasing shareholder wealth. But it can be justified as: (1) redistributing corporate profits; (2) satisfying tastes for voting; (3) placing powerful institutions under voting control, which is inherently desirable; or (4) as a way of counteracting insulation from social and political forces so as to obtain compliance with external legal constraints. The desirability of shareholder initiative, on the assumption that it would make shareholder voting effective, depends on the desirability of these alternative corporate-law ends. This is ironic because shareholder initiative’s fiercest academic proponents also support shareholder wealth maximization as corporate law’s end. The fiercest supporters of shareholder initiative have been bamboozled.

The growth and changing nature of institutional holdings in the United States will make the debate over shareholder initiative the new doctrinal locus of the debate over corporate law ends. The effect of this debate may be a beneficial repoliticization of corporate law—a renewed recognition of its public-law component—and a renewed focus on the political- and social-incentive-creating forces that operate in the presence of market insulation. The economic analysis of corporate law has taken us too far from the study of what Lon Fuller called the “attitudes and conceptions of rightness . . . the obscure taboos and hidden reciprocities which permeate business and social relations.” That is not to say, however, that it cannot now take us in the right direction.

91. Bebchuk, for example, emphasizes this point:

some supporters of greater shareholder power might regard increases in “shareholder voice” and “corporate democracy” as intrinsically desirable. I should therefore stress at the outset that I do not view increasing shareholder power as an end in and of itself. Rather, effective corporate governance, which enhances shareholder and firm value, is the objective underlying my analysis. From this perspective, increased shareholder power would be desirable only if it would operate to improve corporate performance and value.

Bebchuk, supra note 1, at 842-43.

92. FULLER, supra note 27, at 64-65.